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IN THE

Supreme Court of the United States

THE DOW CHEMICAL COMPANY AND SUBSIDIARIES,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

BRIEF *AMICI CURIAE* OF THE AMERICAN CHEMISTRY COUNCIL, THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, AND THE NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

1. Whether the Sixth Circuit erred by holding, in direct conflict with at least five circuits (but in accord with at least two others) that the trial court's determination on economic substance is subject to *de novo* review.

2. Whether the Sixth Circuit erred by creating, in direct conflict with the decisions of this Court and other circuits, an exclusionary rule for economic substance cases that bars consideration of future taxpayer investment merely because the taxpayer has engaged in a long-term transaction in which a substantial portion of its out-of-pocket expenditure is deferred.

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INTEREST OF *AMICI CURIAE* [1]

The American Chemistry Council ("ACC") represents the leading companies engaged in the business of chemistry, a $550 billion enterprise and a key element in the nation's economy. ACC members apply the science of chemistry to make innovative products and services that make the lives of people throughout the country and abroad better, safer and healthier. The ACC supports these endeavors by, among other things, filing *amicus curiae* briefs in matters of importance to this critical sector of the economy.

The Chamber of Commerce of the United States of America ("Chamber") is the nation's largest federation of business companies and associations. It represents an underlying membership of more than three million business, trade and professional organizations of every size, sector and geographic region of the country. One of the Chamber's primary missions is to represent the interests of its members by filing *amicus curiae* briefs in cases involving issues of national importance to American business.

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing in America's economic future and living standards. In support

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[1] Pursuant to Supreme Court Rule 37.6, *amici* state that the brief was authored in its entirety by *amici curiae* and their counsel. No monetary contribution toward the preparation or submission of this brief was made by any person other than *amici curiae*, their members and their counsel. By letters filed with the Clerk of the Court, petitioner and respondent have consented to the filing of this brief.

of this mission, the NAM regularly files briefs *amicus curiae* in this Court and other courts.

While *amici* do not themselves own corporate-owned life insurance policies and take no position with respect to them, *amici* have a compelling interest is ensuring that their member companies receive clear guidance from this Court about the nature of acceptable corporate finance structures under the tax code. These include economically sound, frequently used investment and financing tools in which companies defer some payment on an obligation. The Sixth Circuit's decision—both for the rule it announces and the uncertainty it creates—forces companies to reconsider those strategies, which can increase the cost of capital and hurt the bottom line of America's businesses. To vindicate those important business interests, *amici*, of whom petitioner is a member, respectfully submit this brief.

SUMMARY OF THE ARGUMENT

This case raises questions of great importance to the business community in the United States. *Every* deduction or credit claimed by a company filing a tax return in the United States must satisfy at least two requirements. First, it must comply with the technical requirements of the Internal Revenue Code. Second, the transaction giving rise to the claimed deduction or credit must have "economic substance." Due to the ubiquity of the "economic substance" doctrine, businesses heed its precise contours. Even slight changes in the doctrine affect the tax treatment of countless transactions and, consequently, influence business decisions about how to raise, allocate and reallocate capital. *See* Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 6 (2000) ("[T]he economic substance doctrine has been used to deny tax benefits aggregating to many billions of dollars.").

In this case, the Sixth Circuit's split decision could work a monumental shift in the operation of the "economic substance" doctrine and, consequently, affect corporate capital

financing strategies. Critically, the majority held that evidence of a transaction's eventual profitability *must be excluded as a matter of law* where that profitability depended on optional future capital infusions "seriously depart[ing]" from the taxpayer's past conduct. (Pet. App. 13a) The *only* authority cited for this sweeping exclusionary rule was a footnote from *Knetsch v. United States*, 364 U.S. 361, 366 n. 3 (1960). In doing so, as the dissenting judge explained, the majority "read into *Knetsch* far more than the Supreme Court wrote in that case . . . ." (Pet App. 22a). *See also* Crystal Tandon & Sheryl Stratton, *Korb, Former IRS Officials Discuss Recent Shelter Cases*, 112 Tax Notes 1113 (Sept. 25, 2006) (characterizing one tax practitioner's view of decision below as follows: "The Sixth Circuit's view in no way follows from the *Knetsch* case on which it relied."). Not only did the majority depart from this Court's past decisions, it also parted company with its sister circuits. As one respected tax commentator recently noted, the majority "interpreted *Knetsch* . . . in a manner in which no court had interpreted that case before." Richard M. Lipton, *What Will be the Long-Term Impact of the Sixth Circuit's Divided Decision in* Dow Chemical, 104 J. Taxation 332, 337 (2006). The decision below therefore "means that all of the settled wisdom concerning the meaning of [*Knetsch*] is now called into question." *Id.* Just recently, the IRS's Chief Counsel recognized the potential need for this Court's guidance on the economic substance doctrine in light of decisions like the one below. *See Korb Acknowledges U.S. Supreme Court May Need to Clarify Economic Substance*, Daily Tax Rep. (BNA) (Oct. 27, 2006).

The implications of this novel and unprecedented interpretation of *Knetsch* are potentially quite sweeping. A variety of widely used, well accepted and economically sound corporate finance structures rely precisely on discretionary future capital infusions by the taxpayer. The Sixth Circuit's categorical exclusion of such evidence complicates the future use

of such structures. Not only does the Sixth Circuit's exclusionary rule hamper companies' efforts to justify their programs in "economic substance" disputes with the Government, more importantly it forces risk-averse companies to modify or, yet worse, abandon these important financing schemes precisely to avoid such time-consuming and costly disputes.

Just as the Sixth Circuit's reshaping of the economic substance doctrine warrants *certiorari*, so too does its holding regarding the proper standard of review. *Amici* agree with petitioner that the Sixth Circuit's decision to review economic substance determinations *de novo* further deepens a mature split among the federal courts of appeals over this question. That issue is of critical importance to the American business community, for, in recent years, it has consistently benefited the Government, not the taxpayer, on appeal. This case presents the ideal vehicle in which to resolve the split on this important issue—the Court has a fully developed factual record, and this is one of those exceptional cases in which the standard of review truly is outcome determinative.

In sum, in addition to the reasons offered in Dow's petition, granting a writ of *certiorari* is necessary to address the issues of great importance to the American business community implicated by the decision below.

ARGUMENT

I. *CERTIORARI* SHOULD BE GRANTED TO ADDRESS THE IMPORTANT IMPLICATIONS OF THE SIXTH CIRCUIT'S DECISION FOR A VARIETY OF ECONOMICALLY SOUND TRANSACTIONS THAT DEPEND ON FUTURE PAYMENTS BY THE TAXPAYER.

A. The Sixth Circuit's Fuzzy Exclusionary Rule Calls Into Doubt a Substantial Number of Important Corporate Finance Transactions, the Economic Rationale of which Depends on Future Payments by the Taxpayer.

This case concerns relatively simple, but extremely important, principles of corporate finance. Every day, American businesses must make purchasing decisions and financing decisions. In this case, for example, petitioner had to decide how to cover its retirees' benefits several decades in the future while not encumbering too much of its capital until those obligations became due. That purchasing decision is not unlike ones that American businesses make every day – whether to buy a piece of equipment, lease an office building or buy another company.

Equally important as the purchasing decisions are financing decisions, which are at the core of this case. A company may take out a loan (perhaps with a deferred payment schedule or a balloon payment). It may choose to sell certain assets (and, thereafter, lease them back). It may choose to leverage its assets (akin to a mortgage). It may choose to invest a stream of capital (either from its existing capital reserves or from borrowed funds). These choices will depend on, among other things, how much money the company has, how much it requires, how much it projects having at future points in time, the state of the capital markets and the cost of the various options.

In addition to these considerations, the choices will also depend on the tax implications. As this Court has long recognized, "[w]e cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." *Frank Lyon Company v. United States*, 435 U.S. 561, 580 (1978); *Commissioner of Internal Revenue v. Brown*, 380 U.S. 563, 579-580 (1965) (Harlan, J., concurring). *See also* Pet. App. 27a (Ryan, J., dissenting) ("[C]orporations operate in a world with taxes and . . . some investments are tax favored."). The form of a transaction (*e.g.*, whether to borrow money, sell an asset, mortgage an asset or raise capital) can dramatically affect its treatment under the tax code and, consequently, affect its overall cost.

Of course, under this Court's precedents, a taxpayer is not entitled to every claimed deduction. The judicially created "economic substance" doctrine bars a taxpayer from receiving a deduction or claiming a credit where a transaction lacks "any practicable economic effects other than the creation of income tax losses." 4 Mertens, *Law of Federal Income Taxation* §22.31 at 85 (Cum. Supp. 2006). Critically, this doctrine applies to *any* transaction giving rise to a deduction or credit. *See Lerman v. Commissioner*, 939 F.2d 44, 52 (3d Cir. 1991) (citing *Gregory v. Helvering*, 293 U.S. 465 (1935)). Consequently, judicial modifications of the doctrine have the potential to affect a virtually limitless array of transactions giving rise to deductions, not just the particular transaction before the court. *See generally* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law. 235, 241 (1999); Bankman, 74 S. Cal. L. Rev. at 29.

The Sixth Circuit's decision represents such a modification with sweeping implications. This is the critical portion of the decision:

> Courts may consider future profits contingent on some future taxpayer action, but only when that action is consistent with the taxpayer's actual past conduct. Courts should be skeptical, however, when the asserted future

> profits hinge on future taxpayer action that seriously departs from past conduct, especially where such departure involves the expenditure of large sums of money. (Pet. App. 13a) (footnote omitted).

As Judge Ryan correctly explained in dissent, "there is no such precedential rule of law and no warrant for creating one in this case." (*Id.* at 21a). The majority cites no authority for this newly minted rule of evidence apart from a footnote in *Knetsch v. United States*, 364 U.S. 361, 366 n. 3 (1960), which, as Dow explains (Pet. 20-21), the majority misreads. *See also* Lipton, 104 J. Taxation at 337 ("The majority [in the decision below] appeared to create a legal requirement based on *Knetsch* out of thin air . . . .").

This gross departure from this Court's precedents alone warrants *certiorari*, if not summary reversal. Apart from this deviation from settled law, the decision below also warrants this Court's review due to the importance of this newly minted "exclusionary rule" for the nation's business community. The sections that follow explain the impact of that rule on the capital financing choices that businesses must make.

1. *The decision below fails to provide the clarity that businesses need to make capital financing decisions.*

This Court repeatedly has emphasized the importance of clarity in the nation's tax laws. *See, e.g., Department of Revenue of Oregon v. ACF Indus., Inc.*, 510 U.S. 332, 344 (1994); *Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 223 (1992). Clear rules enable businesses to adopt capital financing strategies qualifying for favorable treatment under the nation's tax laws. They are especially important in the economic substance context for, as noted above, the doctrine bears on any claimed deduction or credit under the Internal Revenue Code. Yet, in three interrelated ways, the Sixth Circuit's rule undermines the necessary clarity that businesses require.

First, the decision below offers absolutely no guidance on the scope of the taxpayer's "past conduct." Is the relevant "conduct" only the taxpayer's conduct in the contested transaction? Does it encompass "conduct" in similar transactions? In all prior transactions? How is a new company, which may literally have no "past conduct" and yet may be precisely the company needing to engage in a prospective payment transaction, supposed to establish its entitlement to introduce evidence of the economic substance of the transaction? Clear answers to these questions are critically important. They enable a company to determine whether a particular capital financing strategy runs afoul of the Sixth Circuit's rule. Moreover, as explained in further detail below, *infra* at 17, they also may determine the scope of discovery that the Government can seek from a company in a contested transaction. Despite their importance, however, the decision below offers no guidance to businesses on these critical questions.

Second, even if the domain of evidence relevant to the "past conduct" inquiry could be established with any clarity, the decision below likewise is wholly opaque on what constitutes a "departure" from past conduct, much less a "serious" one. What if the taxpayer has had ten prior transactions with prospective payments and made the payments in nine cases? Eight? What is the minimum number? Is it absolute? Is it relative to the number of total transactions? What if the taxpayer is a new company and, by definition, has no "past conduct" from which a "departure" can be measured? Again, the American business community searches the Sixth Circuit's decision in vain for answers.

Third, even if the foregoing two hurdles can be overcome, what are we to make of the loose language at the end of the holding indicating that courts should be "especially" skeptical where a departure "involves the expenditure of large sums of money?" What does the Sixth Circuit mean by this last phrase? Is $1 million a large sum? $10 million? $100 million? Is it an absolute term? One relative to the com-

pany's balance sheet? Here too, the decision below offers no clarity and thus hinders predictability.

The lack of answers to these critical questions highlights the importance of the questions presented by this case. Unless the decision below is corrected *promptly*, companies are left to guess about its scope and, consequently, its impact on a variety of economically sound, frequently used capital financing strategies. As one tax practitioner recently explained, the decision below "threaten[s] the tax legitimacy of many transactions that . . . take time and more than one contribution of cash to generate profits. . . ." Tandon & Stratton, 112 Tax Notes at 1113. The following subsections describe some of those transactions and demonstrates how the Sixth Circuit's decision undermines their security.

2. *A substantial number of corporate finance transactions depend on future discretionary conduct by the taxpayer.*

In the Sixth Circuit's view, the critical flaw in Dow's transaction was that its profitability depended on optional future cash contributions by Dow. Pet. App. 13a. Despite the strong economic incentive for Dow to make these future contributions, the Sixth Circuit decided simply to ignore them in its economic substance analysis.

While the Sixth Circuit applied this rule in the particular context of corporate-owned life insurance policies, it has far broader implications. A variety of economically sound, frequently used capital financing strategies—including ones previously approved by this Court, other courts and the IRS—also rely on future discretionary or optional activity by the taxpayer. While space constraints do not permit an exhaustive review of all the transactions affected by the Sixth Circuit's rule, *amici* highlight several important ones here:

Options and Forward Contracts: Companies routinely issue instruments that entitle the holder to shares of stock at some future point in time. Depending on the circumstances, those

instruments may be characterized as "options," "forward contracts," "secured financing" arrangements, or "current sales." The characterization has critical tax consequences for both the issuing company and the instrument holder. For example, a put option may be recharacterized as a contract for sale; the effect of that recharacterization may be to disallow certain capital losses. *See* Rev. Rul. 85-87, 1985-1 C.B. 268. To decide whether to recharacterize the option, a long line of authority has instructed that the relevant considerations include whether there is a "substantial likelihood" that the option will be exercised. *See, e.g.*, Rev. Rul. 85-87, 1985-1 C.B. 268; Rev. Rul. 82-150, 1982-2 C.B. 110.

The Sixth Circuit's decision conflicts with this approach. Under the logic of the decision below, a court (and the IRS) would have to ignore the "substantial likelihood" that the option would be exercised. Instead, because the option, just like Dow's premium payments, depends on contingent future taxpayer conduct, a court would have to treat the instrument as if it were an unexercised option (unless the taxpayer could point to "prior conduct").

More importantly, companies and individuals might abandon a transaction altogether due to uncertainty over how to predict the transaction's characterization. In this setting, open questions over the meaning of "prior conduct" in the Sixth Circuit's rule have real bite. Would it suffice for the taxpayer to show that it had exercised options in *any* prior transaction? Or would the transaction have to be identical to the one under review? Given the centrality of "prior conduct" to the inquiry, the characterization of the transaction could well vary from taxpayer to taxpayer. For example, in the case of a taxpayer who has an established history of exercising an option, the instrument might be characterized as a "current sale." By contrast, in the case of a taxpayer who lacks such a history, a court (and the IRS) would have to treat precisely the same instrument as an unexercised option. The shifting

characterization of the same instrument would render their use virtually unworkable in the marketplace.

Sale/leaseback with a repurchase option: A sale/leaseback is another frequently used capital financing device depending on future conduct by the taxpayer. *See generally* Note, *Sale-Leasebacks: A Search for Economic Substance*, 61 Ind. L.J. 721 (1985/1986). Under the standard sale/leaseback, the company needing the capital sells an asset to another company. The buyer then leases the asset back to the seller. In some cases, the sale/leaseback may include repurchase options. The seller/lessee may have a "call option" under which it may repurchase the relevant asset at a set price; additionally, the buyer/lessor may have a "put option" under which it may sell the relevant asset at a set price.

This transaction yields substantial economic benefits for both parties. From the seller's perspective, the transaction provides an immediate front-end infusion of capital. It may enable the seller to realize 100% of the capital value of the sold asset at the beginning of the transaction, something that makes this transaction particularly important to companies in capital-intensive industries. The seller may use this infusion of capital to finance its operations and generate downstream income without the need to assume debt. From the buyer's perspective, the transaction provides a stream of future income in the form of lease payments.

Apart from its economic benefits, this transaction also has tax benefits. The seller generally can deduct the lease payments from its taxes. *See* 1 Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders §4.01[5] (Cum. Supp. 2006). Depending on the asset's value and the seller's basis, the seller also may be able to time the transaction to generate a capital loss and, thereby, offset other capital gains. *See id.* §5.03[3]. The "option" feature also enables the seller/lessor to take advantage of future depreciation once it regains ownership of the asset following the option's exercise.

This Court and others previously have approved true sale/leasebacks (including those with optionality features) as a capital financing structure. *See Frank Lyon*, 435 U.S. at 583-84; *American Realty Trust v. United States*, 498 F.2d 1194, 1198 (4th Cir. 1974). As with the above-described forward contracts, however, the characterization of the transaction can have critical tax consequences. For example, the sale/leaseback might be recharacterized as a type of "financing" or "loan" secured by the property, which can affect a taxpayer's ability to claim depreciation deductions. *See Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939). Alternatively, the put/call option (whether or not contained in a sale/leaseback) may be recharacterized as a sale, which can also affect a party's ability to claim certain depreciation or interest deductions. *Compare Kwiat v. Commissioner*, T.C. Memo 1992-433, 64 T.C.M. (CCH) 327 (recharacterizing lease with reciprocal put/call options as sale), *with Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978) (declining to recharacterize transaction with reciprocal put/call options as sale) and *Griffin Paper Corp. v. Commissioner*, T.C. Memo 1997-409, 74 T.C.M. (CCH) 559 (distinguishing *Kwiat* and declining to recharacterize reciprocal put/call options as immediate sale). In this context, a critical question in determining the proper characterization is the likelihood that the option will be exercised at the date of inception.

Again, the Sixth Circuit's analysis is inconsistent with this emphasis on the parties' economic incentives. For example, the exercise of the "option" in a sale/leaseback (or any transaction with a reciprocal put/call option), just like the future premium payments in Dow, depends on future conduct by the taxpayer. Even though at least one party may have a powerful economic incentive to exercise the option, that incentive does not suffice under the Sixth Circuit's rule. Unless the taxpayer can point to a conformity between the option's exercise and its own prior conduct, the "option" feature *must* be ignored for tax purposes.

Forward contracts and sale/leasebacks with an optionality feature represent just some of the myriad transactions called into doubt by the decision below. While page limits prevent complete discussion of other affected transactions, briefly they include

- *Sale with Repurchase Option*: This transaction resembles the above-described sale-leaseback except it lacks the lease feature. In this type of transaction, questions again arise over how to characterize ownership of the asset in light of the original seller's likelihood of repurchasing the asset in the future. If exercise of the option is virtually inevitable, then the sale might be effectively ignored, and the transaction recharacterized as a short-term "loan" from the buyer to the seller. In that case, the difference between the original sale price and the repurchase price may be treated as potentially taxable "interest income" to the buyer. In determining how to characterize such a transaction (whether as a sale with an option or a loan), this Court and others have focused on the economic realities of the transaction and the parties' incentives. *See, e.g., Nebraska Dep't of Revenue v. Lowenstein*, 513 U.S. 123 (1994); *Comtel Corp. v. Commissioner*, 376 F.2d 791 (2d Cir. 1967). Yet under the Sixth Circuit's rule, a court would have to ignore the "option" feature (for it would depend on contingent future action by the taxpayer) and instead treat the transaction as a sale with completely different tax consequences.

- *Forward Purchase Contract/Note Units*: In Revenue Ruling 2003-97, the IRS was asked to offer an opinion on whether a corporation could deduct interest in a complex transaction involving investment units. In the transaction, the company issues a two-part instrument: one part is a forward-purchase contract under which the contract holder agrees to buy a quantity of the company's stock in the future; the other part is a note, a basic debt instrument used to raise capital.

> The company initially issues the purchase contract and the note as a single unit, but, depending on the circumstances, the buyer has the option to split the unit and remarket it. Tellingly, the IRS indicated that the Code permits the interest deduction under certain circumstances. *See* Rev. Rul. 2003-97, 2003-2 C.B. 380. A "critical factor" for the IRS was the "substantial[] certain[ty] that the remarketing of the Notes [would] succeed." *Id.*. Under the Sixth Circuit's rule, though, that factor might be irrelevant. As with the premium payments in Dow, this facet of the transaction depends on future conduct. Of course, unlike Dow, the future conduct here is that of the noteholder, not the taxpayer (*i.e.*, the company seeking the interest deduction). Whether that distinction ultimately matters to the Sixth Circuit is unclear—which is precisely why the Sixth Circuit's decision is so dangerous. As with the other above-described transactions, that uncertainty may discourage parties from undertaking an economically desirable transaction.

In sum, the decision below calls into doubt these and other economically sound transactions that depend on future discretionary activity by the taxpayer.

3. *The "contract" exception to the Sixth Circuit's exclusionary rule is incoherent in theory, is ignored by the Government in practice and, therefore, calls into doubt an even broader array of transactions.*

The Sixth Circuit attempts to hedge the impact of its exclusionary rule in a footnote. There, the court states:

> [I]f a taxpayer were *contractually obligated* to infuse additional cash into an investment at some point in the future, such spending would not constitute a serious departure from past conduct that should be disregarded under *Knetsch*. Instead, the eventual outlay would be consistent with actual past conduct, i.e., the obligation

> that existed all along. (Pet. App. 15a, n. 14) (first emphasis added).

This purported limitation makes no sense. For one thing, the court does not explain *why* a contractual obligation establishes that future payments do not substantially depart from past conduct. By their very nature, contracts are obligations made in the present time to undertake some action *in the future*. *See Franconia Assocs. v. United States*, 536 U.S. 129, 142 (2002). It therefore is hard to see how such a future obligation can shed light on past conduct.

For another thing, contracts are not necessarily ironclad guarantees of future performance. They ultimately depend on the willingness of the contracting parties to honor their obligations and, reciprocally, enforce their rights. For example, a parent company may enter into a contractual obligation with its subsidiary. Even though the parties technically may have a contractual obligation, they may have actual little incentive ultimately to perform that obligation. Under the Sixth Circuit's decision, it is unclear whether a court would honor the form of the transaction (because obligations have been reduced to contract) or would create yet a further "exception to the contract exception" where the contractual obligation is illusory.

Finally, the Government itself has refused to recognize this limit on the Sixth Circuit's rule. In a recent case, the Government argued that "the creation of binding obligations between parties is *insufficient* to create economic substance for federal tax purposes." Memorandum of the United States in Support of Second Motion for Summary Judgment in *Xcel Energy, Inc. v. United States*, No. 04-CV-1449-PJS-RLR (D. Minn. Aug. 18, 2006), *available at* 2006 WL 2727375 (emphasis added). Similarly, the Chief Counsel of the IRS described the decision below in terms that gave no significance to the contract exception. Sheryl Stratton, *Korb Praises, Practitioners Question Enforcement Shift*, 113 Tax Notes 394 (Oct. 30, 2006). Thus, even companies that

attempt to avoid the harsh implications of the decision below through contracts have absolutely no assurance that such strategies will avoid costly and burdensome litigation by the Government.

Once the contract exception breaks down in theory—or, more importantly, is ignored by the Government in practice—then an ever wider array of transactions are open to doubt, including ones explicitly approved by other courts:

- *Partnership transactions using full recourse notes*: Individuals or companies may form partnerships to invest in certain assets. Partners may make their capital contribution over time according to a schedule, and the partnership may or may not have recourse against the partner in case of non-payment. *Smith v. Commissioner* involved a case where the partnership generated a loss, and a partner sought to deduct its share of the losses even though it had not paid its contribution in full. 937 F.2d 1089 (6th Cir. 1991). Here, as in the case below, the transaction depended on future action by the taxpayer (namely the unpaid contributions). The Sixth Circuit approved the deduction, yet, if the Government refuses to recognize the contract exception, it might challenge the types of deductions allowed in *Smith*.
- *Foreign subsidiaries*: Companies often establish foreign subsidiaries or entities as a means of either raising capital or insuring against liabilities. *See United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001); *Northern Indiana Pub. Serv. Co. v. Commissioner* ("*NIPSCO*"), 115 F.3d 506, (7th Cir. 1997). For example, in *NIPSCO*, a domestic company had trouble raising money in domestic capital markets due to high interest rates. It established a foreign subsidiary that raised funds from foreign borrowers and lent those funds to the domestic parent. The parent repaid the funds over a payment schedule and sought to deduct the accrued interest payments. Here too, the transaction depended on

> future conduct by the taxpayer. The Seventh Circuit allowed the deduction. Yet if the Government views the contractual obligation between the parent and subsidiary as illusory, then it may seek to disallow the sorts of interest payments allowed in *NIPSCO*.

In sum, given the instability of the "contract" exception and the Government's public position, the decision below calls into doubt an even wider array of capital financing strategies. The next section explains how the insecurity created by the decision below over the enforceability of these transactions will affect actual business practices.

B. The Sixth Circuit's Exclusionary Rule Undermines Fairness in Tax Litigation, Skews Settlement with the Government and Impairs Economically Sound Corporate Finance Practices.

The practical impact of the Sixth Circuit's exclusionary rule on the transactions described above is threefold.

First, the Sixth Circuit's exclusionary rule affects the future of tax litigation with the Government. By excluding evidence of certain contingent future payments from its economic analysis, the decision prevents companies from fully justifying those capital financing tools detailed in Part A, *supra*. Moreover, by connecting the economic substance doctrine to a taxpayer's past conduct, the Sixth Circuit's rule invites fishing expeditions by the Government to probe the taxpayer's business records for years prior to those in dispute. Indeed, the Government already has been citing the decision below in an effort to justify such discovery. *See* Letter of May 19, 2006 from Nathaniel J. Dorfman, U. S. Dep't of Justice, to Judge Timothy S. Hogan, in *Procter & Gamble v. United States* (No. 1:05-CV-00355-MHW) (S.D. Ohio May 25, 2006), *available at*, 2006 WL 1985805.

Second, the decision below does not simply affect cases that result in litigation but also affects a larger number of cases that never reach litigation and are never reported. Like

any governmental agency with investigative powers, the Internal Revenue Service obviously seeks—and prefers—to settle cases rather than invest the resources required by litigation. *See* I.R.S. Manual 31.1.1.1.3 (4), available at *http:// www.irs.gov/irm/part31/ch01s01.html)*; Note, *Using Negotiation, Mediation and Arbitration to Resolve IRS-Taxpayer Disputes*, 19 Ohio St. J. Disp. Res. 709, 709 n. 5 (2004). The dynamics of those settlement discussions turn critically on the parties' expectations about a trial's likely course. The decision below unfairly strengthens the Government's hand by allowing it to argue at the settlement stage that various economic justifications for a capital financing decision are immaterial because the supporting evidence would be inadmissible. *See* Yoram Keinan, *The COLI Cases Through the Looking Glass of the Sham Transaction Doctrine*, 31 Ins. Tax Rev. 31 & n. 176 (July 2006) (describing how favorable results in litigation alter government's settlement strategy). Thus, wholly apart from the *reported* cases affected by the Sixth Circuit's rule, a far greater number of cases, which may never be publicly reported, will be settled differently as a result of that rule.

Third, the Sixth Circuit's decision has even broader implications for corporate finance. Investors, venture capitalists and investment analysts often base their investment decisions and recommendations on an assessment of a company's after-tax rate of return. That assessment necessarily includes both the company's capital financing model and the tax consequences of that model. Doubts about the security and enforceability of a particular capital financing structure may affect a debt rating (thereby increasing the costs of borrowing) or affect an investment recommendation (thereby hurting the company's share price). The uncertainty wrought by the Sixth Circuit's decision calls the security of certain capital financing structures into doubt and, thereby, could affect an assessment of a company's debt and equity instruments.

Certiorari is necessary to correct the potential market distortions wrought by the decision below.

As Justice Thomas speaking for a unanimous Court observed in another tax-related context nearly a decade ago: "[t]he need to avoid litigation and to ensure efficient tax administration counsels in favor of a bright-line standard. . . ." *Arizona Dep't of Revenue v. Blaze Construction Co.*, 526 U.S. 32, 37 (1999). In this case, that principle counsels in favor of *certiorari* where the utilization of important corporate finance tools by the American business community is at stake. Granting *certiorari* will allow this Court to correct the erroneous, muddy rule announced by the Sixth Circuit and, instead, replace it with one that provides clear and proper guidance to American businesses.

II. *CERTIORARI* SHOULD BE GRANTED TO RESOLVE THE RIPE SPLIT AMONG THE FEDERAL APPELLATE COURTS OVER THE PROPER STANDARD OF REVIEW OF ECONOMIC SUBSTANCE DETERMINATIONS.

Dow's petition correctly identifies a split among the federal appellate courts over the proper standard of review of economic substance determinations (Pet. App. 13-19). *Amici* agree with Dow's analysis of this split and briefly offer two additional reasons for why the Court should grant *certiorari* on this issue.

First, the split over the standard of review is an issue of great importance to the nation's business community. In several recent cases, including the decision below, the *de novo* standard has been utilized to upset favorable rulings that taxpaying corporations obtained at the trial level. *See, e.g., TIFD III-E, Inc. v. United States*, 459 F.3d 220, 230-31 (2d Cir. 2006); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *petition for certiorari filed*, No. 06-659 (Nov. 8, 2006). By contrast, in recent cases when the taxpayers lost in the trial court, plenary review of an "economic substance" or similar determination generally did not benefit

them on appeal—the appellate court found in the Government's favor. *See, e.g., American Elec. Power Co., Inc. v. United States*, 326 F.3d 737, 741 (6th Cir. 2003); *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313, 1315 (11th Cir. 2001); *Keeler v. Commissioner*, 243 F.3d 1212, 1217 (10th Cir. 2001). *But see United Parcel Serv. of Am.* 254 F.3d at 1017. Thus, while the *de novo* standard theoretically might benefit either party, practically it benefits the Government.

Second, this case presents an ideal vehicle for resolving the split on this important issue. The record in this case is well developed. The trial judge made extensive factual findings. Perhaps most importantly, as Judge Ryan's dissenting opinion demonstrates, the standard of review is probably outcome determinative in this case. Analyzed under a clearly erroneous standard, the case would have come out differently. (Pet. App. 21a-34a).

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of *certiorari*.

Respectfully submitted,

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